



IFC Management Response to IEG-IFC

Financing Micro, Small, and Medium Enterprises: An Independent Evaluation of IFC's Experience with Financial Intermediaries in Frontier Countries*

Management greatly welcomes IEG's report on financing micro, small, and medium enterprises (MSMEs) in frontier countries through financial intermediaries.

The report cuts across two of the five IFC strategic pillars: (i) strengthening the focus on frontier markets, and (ii) developing local financial markets. MSMEs play an important role in private sector development, particularly in frontier countries, but access to finance has been a constraint in their ability to thrive. Over the years, IFC has tried different approaches to providing finance to MSMEs and found that the most effective way to reach a large number of MSMEs is through financial intermediaries. IFC's worldwide annual net financing commitments for MSME-focused financial institutions (MSME-FIs), during the period 1994–2006 covered by IEG-IFC's evaluation, totaled \$3.8 billion. Of this amount, 38 percent of MSME-FI commitments were in frontier countries.

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Introduction

Management is pleased to note that the IEG's independent study found that IFC's strategy for supporting micro, small, and medium-sized enterprises in frontier countries through financial intermediaries (FIs) has been relevant and effective in promoting successful development and investment outcomes. MSME-FIs have been successful in providing loans to a large number of MSMEs in frontier countries. The study makes three recommendations to further strengthen IFC's contribution to the development of MSMEs through FIs, which will be discussed in detail below.

IEG concluded that FIs were effective channels for wholesaling IFC's financial support to MSMEs because they: (i) provided MSMEs a reliable and accessible source for loans by strengthening the institutional and financial capacity of the intermediaries; (ii) leveraged the resources of MSME-

FIs as well as those of other multilateral development banks and bilateral aid agencies, particularly in the case of microfinance intermediaries; (iii) achieved a high outreach among MSMEs, which IFC could not achieve directly; and (iv) helped to develop and improve the local banking system by, among other things, demonstrating that additional equity capital from IFC can contribute to a profitable lending business line to MSMEs for commercial banks. The report also stated that IFC had a strong additionality through, among others, advisory service (AS), project design, and long-term finance. AS, in particular, tends to be associated with good outcomes, given that small and medium enterprise-oriented financial intermediaries (SME-FIs) that received AS had higher development success rates and a higher average number of borrowers, of about 16,000 per FI, or 10 times more than those that did not benefit from AS.

The study further notes that IFC played significant roles in the success of the MSME-FIs, particularly in structuring MFI projects, establishing a major holding company dedicated to MFIs, and selecting the most suitable SME-FIs. The study states that IFC's roles as a long-term equity investor and proactive shareholder (through its board nominees) in the MFI projects were particularly significant and were only replicated, perhaps, by the European Bank for Reconstruction and Development and the Inter-American Development Bank.

On the environmental, health, and safety (EHS) performance of IFC's MSME-FI projects, the report finds that committed SME management, skilled staff, and good environmental regulations and enforcement in the country of operations promoted EHS sustainability. According to the report, the MSME subprojects visited by IEG achieved higher EHS performance ratings than the MSME-FIs themselves, suggesting that results on the ground were better than the MSME-FIs' compliance with reporting requirements. The study also notes that IFC's EHS supervision

of FIs is expected to improve under the new IFC Sustainability Policy Framework, adopted in May 2006.

The FY94–06 period covered by the IEG study witnessed significant liberalization and internationalization of the financial system in many developing countries—mentioned in detail in the World Bank Group Financial Sector Strategy Paper discussed with the Board in April of 2007. This period, especially in the 1990s, was a turbulent one, with major financial crises in East Asia, Russia, and Latin America. IFC's financial sector activities experienced a very large increase in demand from clients as a result of these two factors and led to important roles for the IFC as a facilitator of foreign investment in FIs located in developing countries, and as a counter-cyclical investor and partner in times of need. IFC's investments in the financial sector therefore increased from \$236 million in FY94 to \$3.3 billion in FY07. Furthermore, MSME finance now accounts for the majority of IFC's financial sector investments, with \$2.5 billion committed in FY07.

Because MSME finance in frontier markets will remain central to IFC's work, going forward, Management values the detailed analysis provided by the IEG study on the effectiveness of IFC's MSME-FI operations, and agrees with the overall direction of the three recommendations IEG made in the report.

Responses to Specific Recommendations

IEG-IFC Recommendation 1:

IFC needs to take a more proactive approach in encouraging other development partners who have substantial engagements with the developing country governments to promote the establishment of specific and prudential regulatory frameworks for microfinance intermediaries in developing—particularly frontier—countries, in order to create conditions that will facilitate the transition of MFIs out of donor dependency, es-

pecially through their development of a savings deposit base and achievement of economies of scale by expanding their client base and the establishment of branch offices.

Management Response:

Management agrees with IEG’s assessment on the importance of the appropriate regulatory framework for microfinance institutions. IFC, mostly through its Donor Funded Facilities has been selectively involved in a high-level dialogue with governments, often in collaboration with the Consultative Group to Assist the Poor (CGAP), to help develop a favorable regulatory environment for microfinance. IFC’s microfinance strategy stresses, however, that the Corporation should selectively engage in these types of advisory assignments and only with the objective of helping to remove binding constraints that hinder access to finance in target markets. Overall, this is a role that CGAP is best positioned to fulfill in view of its mission and staffing profile.

Regarding the second part of the recommendation that MFIs need to develop a savings deposit base and to achieve economies of scale by expanding the client base and branch offices, we believe that microfinance institutions have an important role to play in providing payment and savings services to the poor. It is an important aspect of expanding access to finance, beyond microcredit. Nonetheless, this should also be done selectively, given that not all markets have clear prudential frameworks for MFIs’ deposit-taking function and, even in markets that have the necessary frameworks, not all MFIs are suitable institutions to raise funding through deposits, in particular from their client base, which tends to be of lower income. Because deposits can represent lifetime savings for some clients, it is important to distinguish those financial institutions that have the risk management capabilities, governance structure, and capital base to raise deposits and act in a fiduciary responsibility, from those that have insufficient institutional capabilities.

IEG-IFC Recommendation 2:

IFC could enlarge the scope of its advisory services to MSME-FIs—beyond the present focus of improving lending techniques and loan portfolio risk management, to also help selected MSME-FIs who have achieved good risk management practices to: (i) better meet the need for savings and other banking services (e.g., remittances) by poor households and small businesses; (ii) implement best practice liquidity management procedures; and (iii) in the case of MFIs, help expand their client base to also reach small-size enterprises.

Management Response:

Management agrees that IFC’s advisory services should be made available for a wide range of challenges faced by MSME-FIs. However, IFC should not be routinely prescribing strategic changes to our client institutions. Whether additional banking services should be offered to poor households and small businesses is a business judgment best left to the management and board of each FI. Should IFC face demand from its client institutions to help them develop new banking products, or to better manage their liquidity, then it would be appropriate for IFC to consider providing advisory services responding to that specific need.

IEG-IFC Recommendation 3:

IFC gives a high priority to improving the environmental, health, and safety (EHS) supervision, as well as the EHS compliance rate, of MSME-FI projects. In particular, IEG recommends that IFC set a goal to be achieved within a defined period of time, to improve its satisfactory EHS supervision rate, and the EHS compliance rate of MSME-FI projects.

Management Response:

IFC Management gives a high priority to improving the EHS standards of all projects, including those through MSME-FIs, and this was

the rationale behind the comprehensive policy changes brought about with the new IFC Sustainability Policy Framework, which has been in implementation since May 2006. Among other features, IFC Sustainability Policy Framework includes a sophisticated risk-based appraisal and supervision of FIs. This risk-based approach allows IFC to be more cost effective by allocating more resources in high-risk projects than in low-risk projects, instead of taking a one-size-fits-all approach. The risk-based approach entails an analysis of the FI's portfolio and is carried out during appraisal, to establish the risk level of the FI. The portfolio analysis and the performance of the FI's Environmental Management System are captured in an Environmental and Social Risk Rating (ESRR) measure that is established at appraisal and will be tracked by IFC during project supervision.

Under the 2006 framework, IFC actively engages with the client FI upfront, during the investment appraisal stage, and an EHS plan is established and included in the covenants of the investment agreement between the client FI and IFC. This new approach is a significant improvement over the 1998

policy in which the client was required to establish an Environmental Management System after attending training conducted by IFC. IFC's ability to conduct training for clients in all regions/countries was limited due to staffing and geographical constraints. IFC now makes available one-on-one guidance to high-risk clients, while moving the standardized training to an e-learning platform for greater efficiency. Furthermore, the team strength of EHS specialists working on FI projects has doubled since 2006, and there is a formal supervision plan which entails 100-percent annual supervision of high-risk FIs as well as poorly performing ones.

With the above measures already operational, we expect to see a substantial improvement in the EHS performance of FIs going forward. This view is consistent with IEG's independent finding in the report, which indicates that the new IFC EHS Safeguard Policies and Performance Standards, IFC's EHS mainstreaming initiative, and the creation of an EHS specialist team dedicated to financial markets operations are expected to improve EHS supervision of financial intermediary projects.